How do audits, criminal prosecutions, and publicity affect compliance?

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Smart IRS-Funded Research

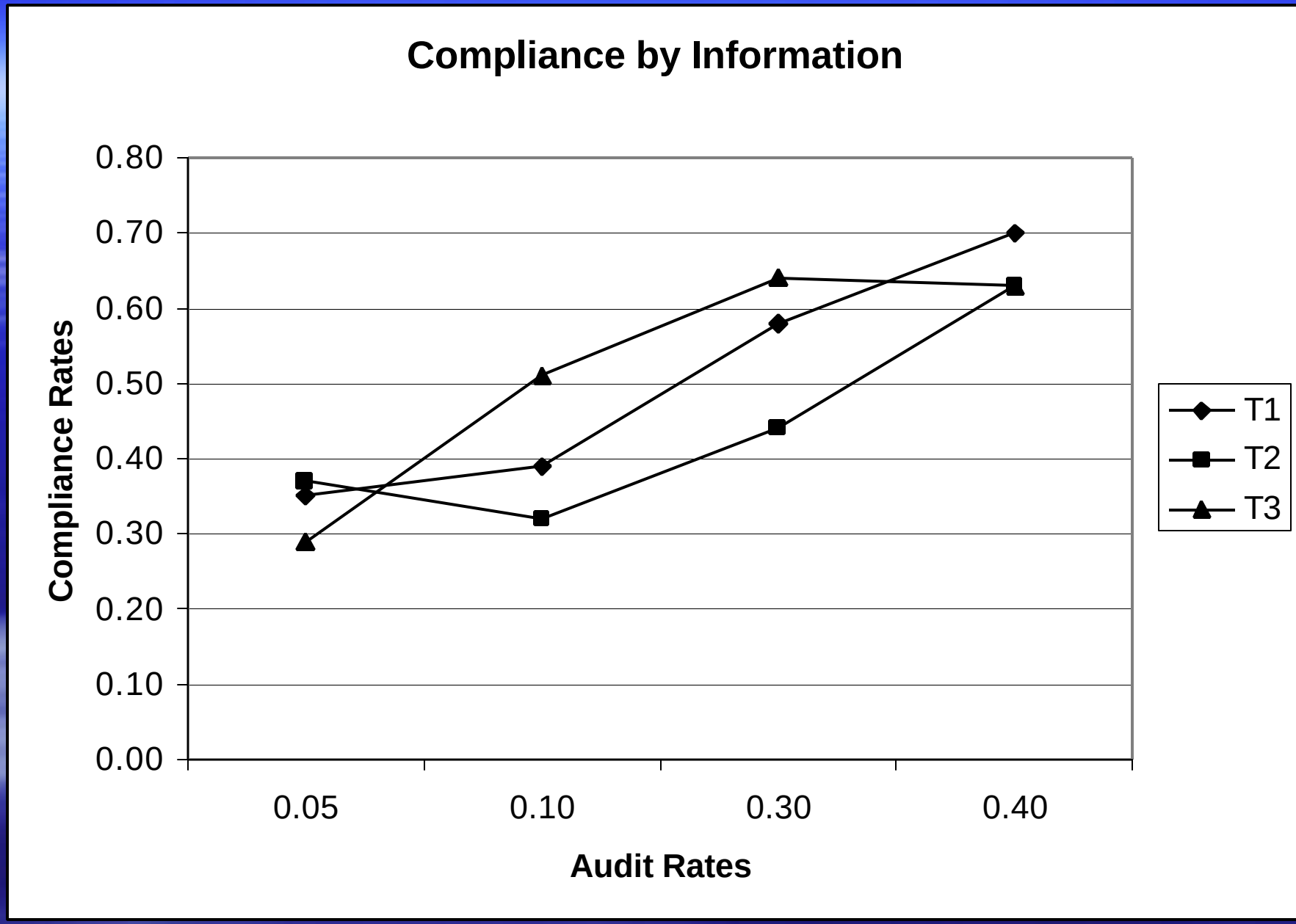
- Well-established scholars with decades of experience in tax compliance studies
- Diversity of approaches
  - Archival data
  - Specialized, intensive study (NRP)
  - Sophisticated experimental study
- Strength comes from “triangulation”
  - Each approach has weaknesses
  - Better than hunches, especially when combined
- Weakness comes from Deterrence Emphasis

Alm, Jackson, and McKee

- Experimental investigation (inexpensive)
  - Reporting income over repeated periods
  - Audit impact
  - Communication: official and personal
- “Realistic tax rate” (.35), penalties (1.5), method of earning income, tax description.
- Problematic: audit rate high, known
  - Unclear role of added Information, learning

The Deterrence Puzzle

- Compliance is best choice IF
  - Tax saving less than expected penalty
  - (1-p)*t*x < p*s*t*x
  - 0.4 < p (or .19 <p if fine based on x)
- Probabilities known to be .5, .10, .30, .40
  - All cheat 100% if p below threshold


Compliance by Information
0.80
0.70
0.60
0.50
0.40
0.30
0.20
0.10
0.00
Compliance Rates
0.05
0.10
0.30
0.40
Audit Rates
T1
T2
T3

Deterrence vs Assurance

- Taxpayer as Gambler
  - Deterrence = Good advice for Dictator or Prison Warden, where no obligation is expected.
- Taxpayer as Contractarian
  - Assurance = Good advice for Democracy, IF obligation can be achieved
- Chester Bowles on Enforcement:
  - 5% Angels, 10% Devils
  - 85% Humans: comply if devils are punished

Audits as Assurance of Tax Contract

- *Obligation to obey diminishes as more people evade*
  - Contractual Compliance in “clubs”—obey rules as long as others do.
  - obligation increases with number of others who obey, with assurance from higher tax rate
  - ‘Better than Rational’– escaping the rational fool dilemma

Contractual Compliance Explains

- *Elaborate tax appeals and court system*
- *Stringent statutory and oversight controls over enforcement*
- *Political isolation of IRS from tax policy*
- *“underinvestment” in audits*
- *Democrats concern with taxpayer services (1970s), Republicans with taxpayer rights (1980s)*
- *IRS attention to “customer” service, helping taxpayers meet obligations of implicit contract*

Audits as Assurance

- Punish Cheaters
  - More audits, more assurance
  - More communication, more assurance at lower audit rates?
- Don’t be intrusive
  - Past audit, less fairness? (control for audit condition)
  - More communication, less assurance?

Table 2 – Possible Messages in Treatment 3 [a]

Do Not Send a Message
I Was Not Audited
I was Audited
I Was Not Audited and Did Not Report all my Taxes
I was Not Audited and Reported all my Taxes
I Was Audited and Did Not Report all my Taxes
I Was Audited and Reported all my Taxes
I paid all my taxes but the auditor still treated me like a crook
I was audited and didn't get caught

a

Dubin: Enforcement impact on estimated compliance

- Natural experiment using archival data– inexpensive, broad, directly relevant approach
- Estimate Compliance indirectly using audit and income data– biggest concern.
- include Criminal Investigations in DWG updated to 1988-2001

Dubin Results

- Double Audit rate => $18.7 Billion
  - One dollar to exam => $58
- Double CI convictions => $16.7 Billion
  - One dollar to CI => $66
- Move dollar from Exam to CI = $6
  - Reallocate internally to make more endogenous!
- Is CI-sponsored result credible???
  - Same result through different funding= more credibility.

Problems of Methodology

- Plumley 1996: "assessed liability", computer matching, linear impact of audits
  - Improved "instrument", but still debatable
  - Improved inclusion of alternative audit, CI
- Assumes consistency over time of:
  - Return types
  - Audit types
  - Tax liability
- Audit results impact CI results—
  - Why inconsistency btn audit rate and number of CI?

Impacts of Criminal Investigations

- Assurance: 2000 prosecutions can influence compliance rates of 100 million taxpayers!!!
  - Bowles: Jail the bad apples
- Any prosecution will do??
  - Contrast with earlier CI studies
  - White Collar?? Any prosecutions??
- Publicity does not play a role!!
  - Weak publicity measure
  - Do Tax Professionals spread the word?

Dubin Lessons

- Fodder for National Policy
  - Estimates out of expected range
  - Method as useful as other flawed estimation for budgetary decisions
- Little use for IRS management decisions
  - Need endogenous allocation of audit, CI resources
  - No confirmation about path of impacts
- Estimates inferior to DCE based on individual audit records–
  - DCE a better foundation for more detailed studies, using return data more directly useful for managers.
  - Need to make available.

Feinstein: Detection-Controlled Estimation of Compliance

- Critical component of new NRP
  - Use audits to measure compliance
  - Use statistics to minimize sample size and need for intrusive methods.
- Classification to minimize intrusiveness
  - Accept
  - Correspondence audit
  - Issue audit
- Calibration sample
  - to “correct” undercounting in each group

Calibration for Compliance Estimation

- Simplest Compliance Estimator:
  - Compare each category with calibration
  - Use “multiplier” to arrive at compliance estimation.
- Problem:
  - Lose much information
  - No correction to help in selecting audits given return characteristics.

Calibration for Compliance Estimation

- Best Compliance Estimator
  - Integrate all information across categories, with appropriate
  - Allows use of line-item characteristic to predict compliance on full sample
- Added advantage:
  - Utilize individual examiner characteristics to account for different detection abilities, to get **highest estimate** of violations in issue audit and calibration sample (problem: will changes hold up under appeals??)

Calibration Complications

- Very small calibration sample size
  - Many hundreds of return characteristics to test, but quickly run out of observations per cell for differences in calibration sample.
  - How limiting for making use of correspondence and issue audits to identify critical return characteristics?
  - How to choose which independent variables to use in critical calibration analysis?
- Zero-change versus amount of change
  - Needs zero-inflated estimators, multiple equation representation?

Improving Examinations

- How can technique produce an improved "DIF" score?
  - Why not incorporate all audits to maximize available data, since DCE needs no sample?
- What procedure produces most accurate categorization for targeting audits?
  - Predict overall $$$ from audit?
  - Predict $$$ per issue?
  - Predict by audit threshold value?

Improving Examinations

- How can current sample be used to do a "Power Analysis?"
  - Estimate added value of increased sample for improving predictions of audit results by increasing number of items that can be used in analysis
- How can DCE be used for Dubin-type study of impacts?

Improving Research

- Needed:
  - Broader access to individual-level data
  - Better Triangulation– integrated studies of same phenomenon using different techniques
- Independent Center for Tax Enforcement and Compliance Research